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No. 85-752

In the

Supreme Court of the United States

OCTOBER TERM, 1985

RALPH MICHAELS, EVERETT B. MICHAELS and EVRA CORPORATION (HYMAN-MICHAELS COMPANY),
Petitioners,

v.

JOSEPH MICHAELS,

Respondent.

BRIEF IN OPPOSITION TO PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

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QUESTIONS PRESENTED FOR REVIEW

The Opinion of the Court of Appeals for the Seventh Circuit (hereinafter "Seventh Circuit") in this case is consistent with opinions of this Court and with opinions of other Circuits in federal securities cases. Furthermore, the Opinion rendered by the Seventh Circuit will have no appreciable impact on securities litigation in the United States. Contrary to the assertions of petitioners in their Petition for Writ of Certiorari to the United States Court of Appeals for the Seventh Circuit (hereinafter "Petition"), no "fundamental legal questions" are raised by the Seventh Circuit Opinion.[1] Rather, that opinion was decided in accordance with this Court's holdings in *TSC Industries, Inc.* v. *Northway, Inc.*, 426 U.S. 438 (1976) and *Ernst & Ernst* v. *Hochfelder*, 425 U.S. 185 (1976). Consequently, further review is not warranted.

The pertinent issues before this Court are as follows:

1. Is the Opinion of the Seventh Circuit, as it relates to the issue of materiality under the federal securities laws, in such conflict with decisions of other Circuits or of this Court as to justify review by this Court?

2. Does the Opinion of the Seventh Circuit raise such fundamentally different legal issues concerning the standard of materiality under the federal securities laws as to justify review by this Court?

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[1] Petitioners are identified as Ralph Michaels, Everett B. Michaels and Hyman-Michaels Company (hereinafter "Hyman-Michaels") in the Petition's Rule 21(b) Statement. (Petition at 1.) However, Hyman-Michaels' interest is at best questionable since the only issue decided against Hyman-Michaels by the trial court and then affirmed by the Court of Appeals—that Hyman-Michaels could not recover on its counterclaim—is not raised in the Petition. Hyman-Michaels has no interest in the issues presented herein relating to the federal securities laws, since Hyman-Michaels was found by the jury not to have violated those laws.

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BRIEF IN OPPOSITION TO PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

STATEMENT OF THE CASE

Introduction

This case concerns a family business which was founded by the grandfather of respondent, Joseph Michaels (hereinafter "Joseph") and which was managed and controlled by petitioners, Ralph Michaels (hereinafter "Ralph") and Everett B. Michaels (hereinafter "Everett"), Joseph's uncles. In January 1976, Joseph was forced by his uncles to sell his interest in this family business. At that time, Everett owned or controlled 50 percent of the outstanding Hyman-Michaels common stock and was Chairman of the Board and Chief Executive Officer of Hyman-Michaels. Ralph owned or controlled 36 percent of the Hyman-Michaels common stock and held the positions of President and Chief Operating Officer.

Joseph was also an officer and director of Hyman-Michaels, owning the remaining 14 percent of its common stock.

On August 16, 1978, Joseph filed this action against Ralph, Everett and Hyman-Michaels, alleging fraud in the purchase of his stock. A jury trial on the issues presented began October 25, 1983. On November 9, 1983, after hearing all of the evidence, the jury returned a verdict for Joseph and against Ralph and Everett on Joseph's claim that they had violated § 10b of the Securities Exchange Act of 1934, 15 U.S.C. § 78j, and Rule 10b-5 promulgated thereunder, 17 C.F.R. § 240.10b-5. The jury also found for Joseph and against Ralph and Everett on Joseph's claims that his uncles had breached their fiduciary obligations to him and in Joseph's favor on his common law fraud claim. The jury awarded Joseph actual damages in the amount of $750,000 on all three claims and further awarded Joseph $200,000 in punitive damages under the common law fraud claim. The jury found for Hyman-Michaels and against Joseph on his claim that Hyman-Michaels had violated the federal securities laws and had breached the warranty provision of an agreement concerning the sale of Joseph's stock to Hyman-Michaels.

The principal argument advanced by petitioners three times in the district court[2], and twice in the Seventh Circuit[3], was that the jury should not have been permitted to determine whether certain information withheld from and misrepresented to Joseph would have been material to a reasonable person in making an investment decision. The gravamen of the Petition to this Court is precisely the same as it was in the courts below, namely, that the jury should

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[2] Petitioners filed and extensively briefed a motion for summary judgment, a motion for reconsideration of the order denying summary judgment and a motion for judgment notwithstanding the verdict or, in the alternative, for a new trial.

[3] Petitioners filed an appeal and a petition for rehearing *in banc*.

have been precluded from hearing the very same information that was intentionally and fraudulently withheld from Joseph.

Statement of Facts[4]

The Hyman-Michaels Company was in the business of purchasing, processing, and distributing scrap iron and steel. In mid-1975, Everett owned or controlled approximately fifty percent of the outstanding voting common stock of Hyman-Michaels, Ralph owned or controlled approximately thirty-six percent, and Joseph owned fourteen percent. On January 27, 1976, Joseph agreed to sell his shares to the Hyman-Michaels Company for $300 a share. Three days later, Joseph delivered the stock, resigned from his offices in the Company, and received $981,276.73. In July, 1976, Everett and Ralph sold the assets of the Company for approximately $13.4 million plus lifetime employment contracts for each of them. (App. 4a-5a.)

Between 1966 and 1976, Hyman-Michaels negotiated with approximately ten different companies in unsuccessful attempts to sell either the Company's assets or the stock owned or controlled by Ralph, Everett, and Joseph. In mid-summer 1975, Ralph began discussions with the Commercial Metals Company ("Commercial Metals") designed to effect a sale of the assets of Hyman-Michaels. The two parties discussed prices, based on asset value, of approximately $14 million. On September 5, 1975, while the Commercial Metals negotiations were ongoing, Ralph, Joseph, and Al Moeng (a

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[4] Because petitioners have failed to accurately or fairly recite the facts stipulated prior to trial, adduced at trial and found by the district court and the Seventh Circuit, respondent has, for the convenience of the Court, reproduced substantially all the facts found by the Seventh Circuit as and for his Statement of Facts. *See* Appendix to the Petition (hereinafter "App.") at 4a-9a. Footnotes to this Statement of Facts are comments by respondent, not by the Seventh Circuit.

Hyman-Michaels financial officer) met with Angus Littlejohn, a consultant to International Carbon & Minerals Corporation ("ICM"), and John Samuels, the chairman of ICM, to discuss the possibility of ICM acquiring Hyman-Michaels. A purchase price in the range of $12 to $14 million was mentioned, but Ralph terminated the meeting without further pursuing Samuels's proposal because Ralph felt that the ongoing discussions with another company (Commerical Metals) precluded such a dialogue. Ralph told Littlejohn and Samuels that he would contact them if negotiations with the other company fell through. (App. 5a-6a.)

The Commercial Metals negotiations ended in December, 1975. Worried about Everett's health and the possible problems for Hyman-Michaels if Everett would die and his shares go into probate, Ralph suggested that the Company borrow money and buy back Everett's common stock for $300 per share. This price was less than the stock's book value, but Everett agreed to accept $300 because Ralph said that was all the Company could afford.[5] Ralph and Al Moeng consequently contacted Bruce Simons, a loan officer at the Continental Bank, about borrowing the approximately three million dollars needed to buy out Everett. Ralph also advised Joseph that all three shareholders would need to sign a "unanimous stockholders consent" before the Company could borrow money for Everett's shares. (App. 6a.)

While the Company was negotiating with the Continental Bank for a loan, Ralph told Joseph that, after Everett's stock was purchased, Ralph would own or control about seventy-five percent of Hyman-Michaels's voting stock with Joseph owning approximately twenty-five percent of that stock. Ralph also said that he intended to place his wife and his son-in-law on Hyman-Michaels's Board of Directors when

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[5] Petitioners' claim that "Everett, Ralph and Joseph agreed that $300 was the right price" (Petition at 3) is contradicted by the record and is a perfect example of the inaccuracies that appear throughout the purported "Factual Background" submitted by petitioners.

Everett left the Company. Joseph consequently became concerned about what would happen to his family if he or Ralph died, given Ralph's wife's apparent ill-will toward Joseph's wife. Joseph therefore sought advice from Harrison Fuerst, a friend who practiced law in Cleveland, Ohio. Fuerst suggested that Joseph ask Ralph to accept one of three proposals: (1) that Hyman-Michaels offer Joseph a buy-sell agreement for his stock; (2) that Ralph and Joseph place their stock in a voting trust so that each would have equal votes; or (3) as a last and least desirable alternative, that Hyman-Michaels purchase Joseph's stock at the same time and for the same price that it purchased Everett's stock. (App. 6a.)

Joseph and Fuerst presented these proposals to Ralph, Moeng, and Marvin Chapman, the Company's lawyer, on January 4, 1976. Either Ralph or Chapman rejected the first two proposals, but Ralph agreed to ask the Continental Bank for an additional one million dollars to buy Joseph's shares along with Everett's. Ralph said, however, that he thought Joseph's request would "kill the deal" and that, as far as Ralph was concerned, Joseph was "out" of Hyman-Michaels no matter what Continental said. After this meeting, Ralph and Chapman went to Everett's house to report what had happened; Everett agreed that the Company should buy out Joseph. When Chapman related Joseph's desire not to be kicked out of the Company and lose his job, Everett responded, "I don't give a damn." (App. 7a.)

On January 5, 1976, Ralph and Moeng went to Continental Bank and requested the additional financing to buy Joseph's stock. Later that day, Simons told Ralph that the bank would not loan Hyman-Michaels either the three million dollars originally requested or the four million dollars unless the loan were secured with Ralph's personal guarantee. Moments later, Joseph was summoned to Moeng's office, where Ralph told him, "Joe, you're out. The

bank has said no." Ralph reiterated that Joseph was relieved of all duties at Hyman-Michaels.[6] (App. 7a.)

* * *

Prior to his departure for Europe, Ralph told Joseph that he (Ralph) would try to reactivate interest in a purchase of Hyman-Michaels and promised to report any such interest to Joseph. On January 23, 1976, while in London, Ralph telephoned Angus Littlejohn and told him that Hyman-Michaels was no longer negotiating with Commercial Metals. Ralph asked Littlejohn if ICM and John Samuels were still interested in buying Hyman-Michaels. At Littlejohn's request, Ralph agreed to stay in London an extra day and meet Littlejohn for lunch. (App. 8a.)

After his telephone conversation with Ralph, Littlejohn sent the following telex to John Samuels in New York:

> RALPH MICHAELS OF HYMAN MICHAELS COMPANY CHICAGO, WHOM I AM SEEING TOMORROW, JUST TOLD ME THAT THE PROPOSED SALE OF THEIR COMPANY COLLAPSD [sic] RECENTLY AT THE VERY LAST MINUTE.
>
> I PRESUME THAT WE [ICM] WOULD NOT BE INTERESTED AT THIS STAGE BUT WOULD APPRECIATE YOUR OPINION AS TO WHETHER IT MIGHT APPEAL TO DAVID.

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[6] Continental Bank was never "reluctant" to loan the funds necessary to purchase Everett's and Joseph's stock, as asserted by petitioners. (Petition at 4.) In fact, according to a Continental representative, negotiations with the Bank continued to mid-January 1976. (Trial Tr. 209, 1095.) In addition, contrary to petitioners' claim, there is no credible evidence that Joseph knew about Ralph's purported refusal ever to give a personal guarantee. (Petition at 4, n.2.) Furthermore, even if Joseph had been given that information, there were other alternatives available to Ralph to secure the proposed loans, i.e., an assignment of insurance claims. (Trial Tr. 201–203, 205–208, 820.) These alternatives were also not disclosed to Joseph.

IF THIS IS TO BE PURSUED PLEASE GIVE ME TIME TO FIRST ESTABLISH A POSITION AS BROKER WITH RALPH.

"David" referred to David Lloyd-Jacob, the executive director of Consolidated Gold Fields in North America ("Consolidated") and the president of Azcon Corporation ("Azcon"), who had toured Hyman-Michaels's Hegewisch yard with Ralph in 1974. By telex dated January 24, 1976, but not received by Littlejohn until January 26, 1976, Samuels responded, stating that Lloyd-Jacob "would definitely be interested" but that Samuels first wanted the chance for ICM to buy Hyman-Michaels. (App. 8a-9a.)

On January 24, 1976, Ralph had lunch with Littlejohn. Ralph repeated what he had told Littlejohn the day before and identified Goldman, Sachs as the investment banker Hyman-Michaels intended to retain. Littlejohn mentioned a number of companies that he thought might be interested in acquiring Hyman-Michaels, including Consolidated. Littlejohn then asked Ralph to exclude those companies—including Consolidated—from any agreement Ralph might reach with Goldman, Sachs so that Littlejohn could obtain a brokerage fee if he were able to effect the purchase of Hyman-Michaels by one of those companies. Ralph told Littlejohn: "Get your ducks lined up." (App. 9a.)

On January 26, 1976, Ralph had a luncheon meeting with Everett and Hyman-Michaels's lawyers, Aaron and Chapman.[7] Ralph told the others about his meeting with Littlejohn and described the companies, including Consolidated, that Littlejohn had indicated were potential purchasers of Hyman-Michaels. Joseph—still a stockholder, officer, and director of Hyman-Michaels—was not invited. Ralph told those gathered that Littlejohn was going to contact certain companies, including Consolidated, on behalf of Hyman-Michaels. The next day, still without telling Joseph of Ralph's conversations with Littlejohn, Ralph and Everett

[7] Petitioners fail even to mention this highly crucial meeting in their presentation of the "Factual Background." (Petition at 2–6.)

signed the agreement to buy Joseph's stock. In July, 1976, Ralph and Everett sold the Company's name and assets to Azcon for $13.4 million and lifetime employment contracts.[8] (App. 9a.)

REASONS FOR DENYING THE PETITION FOR WRIT OF CERTIORARI

The decision of the Seventh Circuit of which review is sought, involves no conflict with any decision of this Court or of any other court of appeals. The decision below, which ends a seven-year-old lawsuit, is clearly correct. The issues between the parties have been fully considered in three opinions of the district court and in two opinions of the Seventh Circuit and further review is unwarranted.

Summary

After the district court denied summary judgment, this controversy was submitted to a jury which for two weeks observed witnesses, heard evidence and viewed exhibits. At the close of the evidence, the jury was instructed, among other things, on the standard of materiality. The jury was instructed without objection that an "omitted fact is material when there is a substantial likelihood that under the circumstances the omitted facts would have assumed actual significance in the deliberations of a reasonable shareholder." (Trial Tr. 1714.) *See TSC Industries, Inc.* v. *Northway, Inc.*, 426 U.S. 438 (1976).

After two days of deliberation, the jury found that Ralph and Everett had a) violated the federal securities laws; b)

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[8] Petitioners' self-serving comments about the hypothetical per share value of Hyman-Michaels stock they received, as contrasted with the amount Joseph received as a result of the damage award, are irrelevant. (Petition at 6.) Damages are not determined by the impact they may theoretically have on individuals who violate the law. *See Clark* v. *John Lamula Investors, Inc.*, 538 F.2d 594, 604 (2d Cir. 1974).

breached their fiduciary obligations to Joseph; and c) committed common law fraud. The jury assessed actual and punitive damages against both Ralph and Everett. In a written opinion denying the motion for judgment notwithstanding the verdict and, in the alternative, for a new trial filed by petitioners, the district court found that the jury could have found the alleged omissions concerning Littlejohn to have been material when viewed in "light of all the facts revealed in the record. . . ." (App. 71a.) The Seventh Circuit, in reviewing the appeal and petition for rehearing presented by petitioners, also found that "a reasonable jury could find that, under all the circumstances, there was a substantital likelihood that the withheld information about Littlejohn would have assumed actual significance in the deliberations of a reasonable shareholder," citing *TSC Industries.* (App. 18a.)

I. The Opinion of the Seventh Circuit is Consistent with the Opinions of This Court.

The jury, the district court and the Seventh Circuit all reached their decisions in this case based, in substantial part, on the dictates of *TSC Industries.* Petitioners contend, however, that the opinion of the Seventh Circuit is "diametrically opposed to guiding principles of securities regulation laid down by this Court over the past decade." (Petition at 16.)

Petitioners also make the clearly erroneous statement that the Seventh Circuit has created a new "rule" which is a "radical departure" from the "approaches" of other circuits. (Petition at 10.) Allegedly, this new rule is that "premerger activities of *any* sort are material and must be disclosed whenever anything occurs which might be characterized as resulting in 'brightened prospects' or as a 'change in approach.' " (*Id.*; emphasis original.) Petitioners have, at best, misunderstood the Seventh Circuit Opinion.

The Seventh Circuit Opinion strictly and expressly adheres to the standard of materiality established by this Court in *TSC Industries*, namely,

> an omission or misrepresentation is material if there is a 'substantial likelihood that, under all the circumstances, the omitted [or misstated] fact would have assumed actual significance in the deliberations of the reasonable shareholder.' *TSC Industries, Inc.* v. *Northway, Inc.*, 426 U.S. 438, 449 (1976); *see Sundstrand Corp.* v. *Sun Chemical Corp.*, 553 F.2d 1033, 1040 (7th Cir.), *cert. denied*, 434 U.S. 875 (1977).

(App. 10a.)

Having correctly articulated the standard of materiality, the Seventh Circuit proceeded to determine whether a jury could reasonably have found a) Ralph's retention of Littlejohn as a broker prior to the time Joseph sold his Hyman-Michaels stock and b) Littlejohn's agreement to contact prospective buyers on behalf of Hyman-Michaels, to be material to a reasonable shareholder. (App. 15a.) As part of its determination, the Seventh Circuit examined the evidence elicited at the trial relating to that issue and found that it established the following facts (which petitioners neglected to include in their "Factual Background"):

1. Ralph retained Littlejohn to act as a broker on January 24, 1976. (App. 16a.)

2. Ralph and Everett, but not Joseph, knew that Littlejohn had agreed to contact prospective buyers on behalf of Hyman-Michaels prior to the time Joseph sold his Hyman-Michaels stock. (App. 15a-16a.)

3. Ralph considered his conversations with Littlejohn important enough to report them to Everett and other Hyman-Michaels officers and advisors, but not to Joseph, on January 26, 1976. (App. 16a.)

4. Ralph and Everett refused Joseph's request to delay the closing of the purchase of Joseph's stock six

weeks because an extension "might interfere with any future plans [Ralph and Everett] may have for the sale of Hyman-Michaels." (*Id.*)

5. Ralph had promised to tell Joseph of any developments while Ralph was in Europe regarding the possible sale of Hyman-Michaels but failed to mention anything about his conversations with Littlejohn to Joseph upon his return from Europe. (App. 17a.)

The Seventh Circuit evaluated the above facts in the context of this case and found, in light of *all* the circumstances, that the evidence supported a finding that the information withheld from Joseph was material. (App. 18a.) The Seventh Circuit did not find that "mere intentions, preliminary musings, or in the words of *TSC*, other matters of 'dubious significance,' must be disclosed" as claimed by petitioners. (Petition at 18.) The established facts in this case reveal and the Seventh Circuit concluded that Ralph and Everett had taken specific actions and made specific decisions which they wrongfully withheld from Joseph.

It is also established that Ralph and Everett *knew* the withheld information was material. (App. 16a.) As the Seventh Circuit noted, a major factor in determining the materiality of certain information is the importance attached to it by those who knew about it. (*Id.*) Consequently, the Seventh Circuit Opinion meets *TSC Industries'* objective standard of materiality and focuses "on 'objectively demonstrable facts'" as required by *Blue Chip Stamps* v. *Manor Drug Stores*, 421 U.S. 723 (1975). (*See* Petition at 18.)

By following the guidelines set forth by the Supreme Court, the Seventh Circuit has *avoided* establishing a "rule" and has, instead, complied with the principle that materiality must be determined on a case-by-case basis.[9] In an opinion extremely pertinent to the arguments made by petitioners herein, the court in *SEC* v. *Shapiro*, 494 F.2d 1301,

[9] Petitioners have obviously refused to accept this well-established principle.

1306 (2d Cir. 1974), addressed the issue of whether certain cases created a rule as to when merger negotiations became material:

> Appellant argues that the cases establish a rule as to when information concerning merger negotiations becomes material. We cannot find such a rule. Appellant relies primarily on our decisions in *List* v. *Fashion Park, Inc.*, 340 F.2d 457 (2d Cir.), *cert. denied*, 382 U.S. 811, 86 S.Ct. 23, 15 L.Ed.2d 60 (1965), and *Radiation Dynamics, Inc.* v. *Goldmuntz*, 464 F.2d 876 (2d Cir. 1972)....Neither case supports appellant's argument. In each case the court stated the definition of materiality of non-public information and then applied the definition to the facts before it. In neither case did the court purport to create a specific rule as to when information respecting a merger becomes material. Indeed, when plaintiff in *Radiation Dynamics* suggested such a rule the court responded, citing *SEC* v. *Texas Gulf Sulphur Co., supra*, 401 F.2d at 849, that "such 'materiality' must be determined on a case-to-case basis according to the fact pattern of each specific transaction." 464 F.2d at 888.

In making a determination as to the materiality of a future event, such as the consummation of a sale of assets, a court should balance "both the indicated probability that the event will occur and the anticipated magnitude of the event in light of the totality of company activity." *SEC* v. *Texas Gulf Sulphur Co.*, 401 F.2d 833, 849 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969). As the Second Circuit found in a later case, *SEC* v. *Geon Industries, Inc.*, 531 F.2d 39 (2d Cir. 1976), a case cited by the Seventh Circuit in its Opinion, information concerning an event of great magnitude, for example, an acquisition of a closely-held corporation, is material even if the probability of its occurrence is extremely low. Speaking

specifically of the materiality of tentative merger negotiations, the Court held:

> [T]he application of [the Texas Gulf Sulphur] test implies that there is "[no] specific rule as to when information respecting a merger becomes material," but rather indicates that each case must be approached on its own facts. *Since a merger in which it is bought out is the most important event that can occur in a small corporation's life, to wit, its death, we think that inside information, as regards a merger of this sort, can become material at an earlier stage than would be the case as regards lesser transactions—and this even though the mortality rate of mergers in such formative stages is doubtless high.* In cases of the disclosure of inside information to a favored few, determination of materiality has a different aspect than when the issue is, for example, an inaccuracy in a publicly disseminated press release [citation omitted], or a proxy statement [citation omitted]...; the information takes on an added charge just because it is inside information.

531 F.2d at 47–48; emphasis added.

In *Holmes* v. *Bateson*, 583 F.2d 542 (1st Cir. 1978), the court, in affirming the district court's finding that certain omissions were material, held:

> We find it inconceivable that a reasonable stockholder would not think that the merger information concealed in this case was important and, therefore, material. We think the evidence supports the district court's conclusion that the reason the estate's representatives did not express more interest in possible merger options before the closing wa. that they believed they had received all the information then available. The close relationship between the parties undoubtedly also acted to lull their suspicions.

> We find little merit in defendants' contention that the district court's finding of materiality was clearly erroneous because of substantial errors in its assessment of the total mix of information made to the estate. As we have indicated, we think that the district court correctly analyzed the entire picture and its findings of material omissions and selective disclosures were based on the fact that the information given to the estate was purposely incomplete and inaccurate.

583 F.2d at 558.

In the instant case, Joseph "believed [he] had received all the information then available." Moreover, it is clear that the information given to Joseph was "purposely incomplete and inaccurate" and that the "close relationship between the parties undoubtedly . . . acted to lull [Joseph's] suspicions." *Id.*

In *Thomas* v. *Duralite Co., Inc.*, 524 F.2d 577 (3d Cir. 1975), the trial court found that undisclosed conversations between one defendant and a third party about a possible merger partner for Duralite Co., Inc. were of "critical importance" to plaintiff and further found that, had plaintiff known of the possibility of a purchaser for Duralite, "he would not have agreed to sell the stock at the price he did." 524 F.2d at 584.

The Seventh Circuit followed these decisions in this case:

> *TSC Industries* teaches that the test of materiality is always an objective one. 426 U.S. at 445; *see also Kohler* v. *Kohler Co.*, 319 F.2d 634, 642 (7th Cir. 1963). Even with the objective test, however, the fact that the corporation is small and closely held may affect the materiality of an omitted fact in two respects. First, an event of a given magnitude probably has a larger potential impact on the fortunes of a small company than on the fortunes of a large one. *See, SEC* v. *Geon Industries, Inc.*, 531 F.2d 39, 47–48 (2d Cir. 1976). In addition, what the reasonable shareholder considers important is necessarily a function of his options. The "total mix" of

> information available to the reasonable shareholder includes the probability of being locked into a minority interest of an unprofitable, closely-held corporation. *See, e.g., Thomas* v. *Duralite Co.*, 524 F.2d 577, 581, 584–85 (3d Cir. 1975) (defendant gave plaintiff the impression that the company faced imminent disaster). Thus, although we apply the objective standard of materiality, the significance the reasonable shareholder would give a particular omitted fact depends on the circumstances confronting him. *See TSC Industries, Inc.*, 426 U.S. at 449 ("a substantial likelihood that, *under the circumstances*, the omitted fact would have assumed actual significance in the deliberations of the reasonable shareholder") (emphasis added); *see also* 5A A. JACOBS LITIGATION AND PRACTICE UNDER RULE 10b-5 § 61.02[b][ii], at 3–131 (2d ed. revised December, 1984) ("the hypothetical reasonable man should be presumed to be standing in the plaintiff's shoes").

(App. 13a-14a; emphasis original.)

Clearly, the Seventh Circuit followed the decision of this Court in *TSC Industries* in affirming the trial court's judgment. As is evident from the record, the withheld information was neither "speculative" nor "remote," as petitioners would have this Court believe. (Petition at 19.) Rather, it was information which met *TSC Industries'* standard of materiality, i.e., information which should have been disclosed to a reasonable investor and which could easily have been disclosed to Joseph without misleading Joseph or anyone else.

II. The Opinion of the Seventh Circuit is Consistent With the Opinions of Other Circuits.

The Petition baldly states that the "split in the circuits is clear." (Petition at 9.) Petitioners argue that "the Second, Third, Sixth, Eighth and Ninth Circuits all agree on the necessity of drawing an identifiable line at the point which premerger activities become material. . . . By contrast, the Seventh Circuit in this case has simply erased the line altogether." (Petition at 13.) This is untrue. The cases cited

by respondents are readily distinguishable from this case on their facts. Moreover, the Seventh Circuit has neither acknowledged nor "erased" the alleged "line" petitioners have created for the purpose of this Petition.

The cases cited by petitioners as "in conflict" with the Seventh Circuit Opinion are inapposite to the case at bar for the following reasons:

a) *Greenfield* v. *Heublein, Inc.*, 742 F.2d 751 (3d Cir. 1984), *cert. denied*, 105 S.Ct. 1189 (1985) (Petition at 10–11) is readily distinguishable on its facts and was directly considered by the Seventh Circuit, which found that the "policy underlying that [price and structure] standard is not applicable on the facts of this case." (App. 12a.)

b) *SEC* v. *Geon Industries, Inc.*, 531 F.2d 39 (2d Cir. 1976) (Petition at 11) represents an endorsement by the Court of Appeals for the Second Circuit of the case-by-case test of materiality set forth in *Texas Gulf Sulfur* and adopted by the Seventh Circuit in its Opinion. (App. 14a.)

c) *Reiss* v. *Pan American World Airways, Inc.*, 711 F.2d 11 (2d Cir. 1983) (Petition at 11) is also distinguishable on its facts and was so distinguished by the Seventh Circuit, which found that the need to protect shareholders from potentially misleading disclosure of preliminary merger negotiations discussed in *Reiss* "disappear[s] when there is no public market [as in the instant case] for a shareholder's stock." (App. 11a-12a.)

d) *Starkman* v. *Marathon Oil Co.*, [Current Binder] Fed.Sec.L.Rep. (CCH) ¶ 92,290 (6th Cir. Sept. 13, 1985) (Petition at 12) does not conflict with the Seventh Circuit Opinion herein for the same reason discussed in conjunction with *Reiss*. The *Starkman* court feared that preliminary discussions could mislead public shareholders. However, in the case at bar, there were no public shareholders and no possibility that Joseph would have been misled by the same information Ralph

had previously shared with Everett and with Hyman-Michaels' attorneys.

e) *Missouri Portland Cement Co.* v. *H.K. Porter Company, Inc.*, 535 F.2d 388 (8th Cir. 1976) (Petition at 12) is also inapplicable to the instant case. *Missouri Portland* involved a publicly held corporation whose stock was traded on the New York Stock Exchange and which sought an injunction to block the H.K. Porter Company's offer to purchase 500,000 shares of Missouri Portland's common stock.

f) Finally, *South Coast Services Corp.* v. *Santa Ana Valley Irrig. Co.*, 669 F.2d 1265 (9th Cir. 1982) (Petition at 13) involved proxy materials in connection with a proposed sale of assets. In affirming a judgment for defendants, the Ninth Circuit held that management was required to include only information concerning firm offers more favorable than the offer for which approval was sought in the proxy materials. This case is clearly distinguishable from the case at bar.

Petitioners also argue that the Court made the "unfounded assumption" that there was no danger that disclosure would mislead Joseph and cite *Reiss* in support of that argument. (Petition at 13–14.) However, it must again be noted that *Reiss* did not involve a closely held corporation with only three shareholders; it involved a publicly traded corporation with possibly thousands of shareholders. The court in *Reiss* was concerned about mis-information in the "not unusual circumstances" of one publicly traded company purchasing the stock or assets of another. 711 F.2d at 14. Clearly, the circumstances of this case are readily distinguishable. Equally clear is the fact that petitioners were not misled by the disclosure of the information and that, as noted by the Seventh Circuit, Joseph "could simply ask Ralph and Everett [if he were unsure about the disclosed information] and they could clarify any possibly misleading statement." (App. 13a.) The fact is, disclosure was necessary to ensure that Joseph was *not* misled.

Petitioners seek to denigrate the Seventh Circuit's differentiation between a public and private company, claiming that a "public/private distinction is virtually impossible to apply." (Petition at 14.) This argument is frivolous. As petitioners' own cited authority explains, a closely held corporation may be defined as a corporation, no shares of which are regularly quoted or generally traded. Folk, *Corporation Statutes: 1959-1966*, 1966 Duke L.J. 875, 947. (Petition at 15.) Furthermore, distinctions between different types of corporations are continually being made by the courts and by other entities. For example, in Easterbrook and Fischel, *Mandatory Disclosure and the Protection of Investors*, 70 Va. L. Rev. 669 (1984), the authors specifically point out as follows:

> *The SEC has used its regulatory power to create many forms of disclosure appropriate to the size of the firms and the industries in which they operate.* [Footnote omitted.] There is for example, a special form for mineral extraction corporations. *Larger firms disclose less than others (Schedule S-3, for the largest firms, is quite streamlined in recognition of the fact that markets generate great quantities of information about such firms).*

70 Va. L. Rev. at 701; emphasis added.

The flaw underlying petitioners' entire argument is their contention that the Seventh Circuit has created some kind of "rule" with regard to the disclosure requirements in the context of closely held companies. As a review of the Opinion reveals, this is not so. To the contrary, the Seventh Circuit refused petitioners' request that it *create* a rule that foreclosed the case-by-case determination of materiality mandated by this Court's holding in *TSC Industries*. Following *TSC Industries*, the Seventh Circuit examined the facts of this case and determined that, given *all* the circumstances, a reasonable person would have found the information withheld in this case to be material.

In sum, the Seventh Circuit Opinion is consistent with existing case law on materiality. To the extent the Opinion

clarifies the standard of materiality in securities transactions in closely held corporations, it should result in less—rather than more—litigation by putting shareholders on notice of their duty of disclosure in these transactions.

III. The Position of the SEC in *In re Carnation Co.* Is Irrelevant to the Case at Bar.

The Securities and Exchange Commission (hereinafter "SEC") filed an *amicus curiae* brief in this case in conjunction with the petition for rehearing in the Seventh Circuit. Joseph does not presume to comment on the matters raised therein other than to suggest that the opinions of the Third Circuit challenged by the SEC always appeared to be somewhat at odds with the standard of materiality adopted by this Court in *TSC Industries*. In any event, the SEC in its Motion for Leave to File Its Memorandum, urged "no change in the [Seventh Circuit's] judgment." Motion of SEC For Leave to File Memorandum, ¶ 4.

Joseph respectfully submits that the Petition in this case is an inappropriate vehicle for petitioners to argue the merits of the SEC's report on a private investigation concerning merger negotiations between Carnation Company and Nestle, S.A. (Petition at 20–21.) First, the SEC release referred to by petitioners, *In re Carnation Co.*, Sec. Act Rel. No. 22214 (July 8, 1985), reprinted in (1984–1985 Transfer Binder) Fed. Sec. L. Rep. (CCH) ¶ 83,801, presents a very different factual situation from the instant case.

Second, and most importantly, whether or not the SEC's release represented a "radical departure from established precedent" (Petition at 20), a point denied by Joseph, is totally irrelevant to the case at bar. Similarly, the news articles cited by petitioners relating to that release are not part of the record and have no bearing on this case. (Petition at 21.) Finally, although the release was cited in the Opinion, the Seventh Circuit nowhere found that the SEC release was a "radical departure" in the law or that it merited any particular attention. (*See* App. 12a.) Therefore, petitioners'

attempt to aggrandize the issues before this Court with claims relating to irrelevant pronouncements by the SEC and the news media should be disregarded by this Court.

IV. The Evidence Supports the Seventh Circuit Opinion Regarding the Material Misrepresentation Made to Joseph and Review of the Issue Is Not Warranted.

Petitioners argue that the Seventh Circuit incorrectly concluded that Ralph's statement that the Continental had terminated loan negotiations with Hyman-Michaels on January 5, 1976 was material and that Joseph had relied on it. (Petition at 21–23.) Petitioners are seeking to have this Court review the question. However, there is no constitutional question or conflict in the circuits involved or claimed on the issue. Furthermore, the issue does not even arguably relate to important policy considerations which warrant review by this Court.[10] Supreme Court Rules, Rule 17.

In any event, it is beyond peradventure that Ralph's statement[11] was knowingly, maliciously, and falsely made and that the ultimate harm to Joseph—being forced out of Hyman-Michaels at $300 per share—flowed directly from his belief that he had to sell his stock when he did for what he did because a) the Bank had terminated negotiations with Hyman-Michaels; *and* b) no possibility of another entity acquiring Hyman-Michaels existed; *and*, therefore, c) selling his stock to Hyman-Michaels on January 27, 1976 for "all that Hyman-Michaels could afford" was his only viable option.[12] (App. 14a-15a.) Clearly, had Joseph not believed

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[10] Petitioners cite no case law in support of their argument that the review of this issue is warranted.

[11] "Joe, you're out. The bank has said no." (App. 7a.)

[12] For petitioners to argue that Ralph "gave the most accurate portrayal of the loan negotiations that he could," defies credulity. (Petition at 23.) Ralph's own testimony establishes that it was *his* decision to terminate the loan negotiations, not the Continental's. His statement to Joseph that "the bank has said no" was not an "accurate portrayal." It was a lie.

what Ralph told him, his entire bargaining position between January 5, 1976 and January 27, 1976 would, as Joseph testified, have been different. As the Seventh Circuit noted in its Opinion, Joseph testifed without contradiction that, had he know the truth about negotiations at the Continental, he would never have sold his stock when he did under the terms and conditions that he did. (App. 20a.)

The Petition argues (without citation to the record) that the Seventh Circuit's conclusion that Joseph had to "forego his request that his stock be bought with Everett's and instead to sell only his stock to the Company" represents a "misunderstanding of the record." (Petition at 22.) However, the opposite is clearly true. The Court's conclusion indicates that it has understood the record far better than petitioners. Joseph's request to be bought out of Hyman-Michaels was *only* as a last resort and *only* if Everett were bought out at the same time. (Trial Tr. 168–172.) The finding of the Seventh Circuit to that effect (App. 20a) is consistent with both the record and with Joseph's position before the Seventh Circuit.

Petitioners were not in a "predicament," as suggested by the Petition. (Petition at 23.) They had a simple obligation to tell the one shareholder in Hyman-Michaels who was selling his stock, the same information that was given to the other shareholders. Ralph's and Everett's failure to do so in the context of Ralph's misrepresentation about the negotiations with the Continental has no relation to petitioners' parade of horribles concerning premature disclosure and petitioners' attempt to link the two is totally without merit.

CONCLUSION

For the foregoing reasons, the Petition for Writ of Certiorari to the United States Court of Appeals for the Seventh Circuit should be denied.

Respectfully submitted,

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